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No. 78-401

In the Supreme Court of the United States

OCTOBER TERM, 1978

GAVIN S. MILLAR, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
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Petitioners seek review of the decision below in this federal income tax case holding that they realized gain upon their creditors' foreclosure upon certain stock in satisfaction of non-recourse obligations to the extent that the face amount of the obligations exceeded their bases in the stock.

The pertinent facts are as follows: In July 1964, R. H. Jamison, Jr. formed Grant County Coal Corporation and transferred all outstanding shares of

Grant County stock to members of his family and to various business associates, including petitioners. Thereafter, Jamison loaned the Grant County shareholders a total of $500,000 which they in turn contributed to Grant County's capital. Petitioners received $245,000 of the $500,000 in loans and signed notes evidencing their indebtedness to Jamison and pledged their Grant County stock as security for the notes (Pet. App. 37-43a). The notes provided that all liabilities thereunder were payable "solely and only out of" the Grant County stock, "without other personal liability on * * * [petitioners'] part" (Pet. App. 41a).

Petitioners reported their Grant County stock as having a tax basis equal to the $245,000 principal amount of their contributions to capital. By 1967, however, by virtue of certain concededly proper adjustments, petitioners had reduced their collective tax bases in their Grant County stock from $245,000 to $39,492 (Pet. App. 45a-46a).

Grant County was an economic failure. On January 23, 1967, it filed a petition seeking an arrangement under Chapter XI of the Bankruptcy Act. Immediately thereafter, Jamison sent petitioners letters in which, after noting that petitioners had failed to honor his earlier demands for payment of their outstanding notes, he notified them that he was foreclosing upon their stock. Petitioners acknowledged

the foreclosures. Thereafter, Grant County was declared bankrupt (R. 96a; Pet. App. 44a).[1]

On audit, the Commissioner of Internal Revenue determined that the foreclosures and resulting cancellations of the notes resulted in petitioners' realization of more than $200,000 in taxable gains (Pet. App. 45a-46a, 48a). In this suit for redetermination of the deficiencies, the Tax Court upheld the Commissioner's position (Pet. App. 31a-58a) and the court of appeals affirmed (Pet. App. 1a-10a). Relying on this Court's decision in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), both courts held that petitioners realized taxable gain to the extent that the face amount of the notes satisfied exceeded their bases in the foreclosed stock.[2]

1. One of the cornerstone principles of federal tax law is that the excess of the amount realized on the disposition of property over a taxpayer's tax basis in that property is gain. Internal Revenue Code of

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[1] "R." refers to the record appendix filed in the court of appeals.

[2] This case was twice before the court of appeals. On the first appeal, the court remanded the case to the Tax Court for entry of specific findings whether the advances by Jamison to petitioners were loans or gifts (Pet. App. 22a-30a). On remand, the Tax Court found that the advances were loans and, in a reviewed opinion, reaffirmed its previous decision (Pet. App. 53a-55a) that petitioners realized taxable gain to the extent that the face amount of notes satisfied exceeded petitioners' bases in the foreclosed stock (Pet. App. 11a-12a, 20a). The court of appeals affirmed as to that issue but reversed the Tax Court's imposition of negligence penalties as to one of petitioners (Pet. App. 1a-10a). The negligence penalties are no longer in issue.

1954, Section 1001(a). It is, moreover, well settled that any indebtedness attached to the property must be taken into account in computing both the tax basis and the amount realized on disposition. Accordingly, as a general rule,[3] if a taxpayer assumes or takes property subject to a mortgage, the principal amount of the mortgage is includable in the taxpayer's cost basis in the property. See, *e.g.*, *Crane* v. *Commissioner*, 331 U.S. 1 (1947); *Mayerson* v. *Commissioner*, 47 T.C. 340 (1966). Likewise, when a taxpayer sells or transfers property subject to a mortgage, the face amount of that mortgage is includable in the amount the taxpayer is considered to have realized upon the sale. See, *e.g.*, *Crane* v. *Commissioner*, *supra*; *Teitelbaum* v. *Commissioner*, 346 F. 2d 266, 269 (7th Cir. 1965); *Smith* v. *Commissioner*, 324 F. 2d 725 (9th Cir. 1963); *Commissioner* v. *Fortee Properties*, 211 F. 2d 915, 916 (2d Cir. 1954).

The decision below properly applied these principles in this case. Petitioners contributed to Grant County $245,000 they had borrowed from Jamison and properly claimed tax bases in their Grant County stock equal to the amounts of those capital contributions. Grant County thereafter sustained certain operating losses and made certain distributions of capital on petitioners' behalf. Pursuant to the election they had made under the provisions of Subchapter S of the Code (Sections 1371-1378), petitioners deducted grant County's operating losses on their individual returns (Section 1374) and reduced their bases in their Grant County stock to reflect these losses (Section 1376(b)) and to reflect certain distributions of capital Grant County made for their benefit. After having reduced their collective tax bases in the Grant County stock from $245,000 to approximately $40,000, petitioners then transferred all their Grant County stock to Jamison in full satisfaction of the $245,000 in outstanding notes. Whether that transfer is viewed as an exchange of Grant County stock for the $245,000 originally borrowed from Jamison or as a transfer of property encumbered by a purchase-money obligation, it cannot be denied that petitioners realized $245,000 in consideration for their stock transfers, and realized gain to the extent that the $245,000 exceeded their adjusted bases in the Grant County stock.

Petitioners contend (Pet. 10-12) that the decision below ignores the fact that their debt obligations to Jamison were non-recourse in nature and is contrary to *Crane* v. *Commissioner*, *supra*. The result does not ignore the non-recourse nature of the Jamison notes, but rather flows directly from that fact. Because the debts here were non-recourse in nature, petitioners never suffered any direct financial loss in these foreclosures. Petitioners therefore recovered their full investments in Grant County when they

[3] When, in contrast to the present case, there is reason to doubt the bona fide nature of a purchase-money obligation, that obligation might not qualify as an element of "cost" for tax basis purposes. Rev. Rul. 77-110, 1977-1 Cum. Bull. 58. But petitioners do not contend that their obligations were not bona fide. Cf. *Mayerson* v. *Commissioner*, 47 T.C. 340 (1966).

surrendered their Grant County stock in satisfaction of the outstanding notes. Thus, the case is distinguishable from *Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170 (1926), upon which petitioners rely (Pet. 9), since there the taxpayer actually suffered an economic loss.

Crane v. *Commissioner*, *supra*, fully support the decision below. In *Crane*, this Court held that when property is old subject to a non-recourse mortgage, the outstanding mortgage balance is includable in the gross sales price realized by the seller. To be sure, as the decision below pointed out (Pet. App. 4a-5a), this Court noted in *Crane* (331 U.S. at 14 n.37) that the property there at issue was worth more than the face amount of the outstanding non-recourse indebtedness and that "a different problem might be encountered" if the property were worth less than the indebtedness. However, as the court of appeals pointed out (Pet. App. 7a-8a), these observations were not essential to the decision in *Crane* and therefore do not constitute a holding that different rules should apply when the transferred property is worth less than the non-recourse obligations. Nor has any court so read them. Indeed, every court that has addressed the question has concluded that, as long as at the time of acquisition the encumbered property was worth at least the full amount of outstanding non-recourse obligations, then the face amount of such non-recourse obligations must be included in the amount realized by the seller on disposition—no matter what the fair market value of the transferred property might then be. As these

courts have reasoned, no other conclusion would properly reflect the economic consequences of the transfer. *Woodsam Associates* v. *Commissioner*, 198 F. 2d 357 (2d Cir. 1952), aff'g 16 T.C. 649 (1951); *Parker* v. *Delaney*, 186 F. 2d 455 (1st Cir. 1950); *Tufts* v. *Commissioner*, 70 T.C. 756 (1978); *Mendham Corp.* v. *Commissioner*, 9 T.C. 320 (1947); *Lutz & Schramm Co.* v. *Commissioner*, 1 T.C. 682 (1943); See Rev. Rul. 76-111, 1976-1 Cum. Bull. 214; Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 Tax L. Rev. 277 (1978).

The holding below therefore correctly reflects the fact that petitioners here realized fully as much upon their transfer of Grant County stock to Jamison as they had initially invested in the corporation. Since petitioners concede that their adjusted bases in the transferred stock were less than those amounts, they are required to recognize the resulting gain.[4]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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[4] Petitioners err in suggesting (Pet. 11-12) that the decision below constitutes judicial "recapture" legislation. The holding below does not "recapture" the ordinary deductions previously claimed by petitioners, but rather imposes taxes on the long-term capital gain they realized when the proceeds realized in the transfer to Jamison exceeded their adjusted tax bases in the transferred stock. Compare Section 1001 of the Code with Sections 1238, 1245, 1250, 1252; cf. Sections 47, 80, 176 and 617(d) of the Code.

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